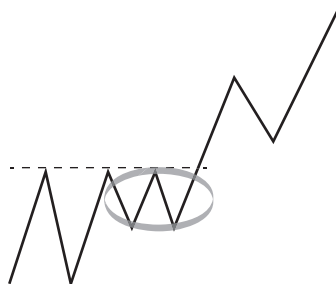


## BREAKOUTS, ENTERING IN THE PRECEDING BASE



### Trade Type

Support/resistance breaking.

**Concept** Breakouts are an important class of trades and can give rise to strong price moves beyond the breakout point. Schematically, there are three places to enter breakout trades: before, after, or on the breakout. Trades entered on the breakout can incur high slippage and poor trade location due to the high volatility and low liquidity that accompany many of these trades; many traders find better success with executing either before or after the actual breakout. We will first look at some characteristic patterns preceding good breakouts in which the market tips its hand and shows that energy is being built up to support the breakout. (Think classic accumulation.) It is possible to enter in these formations preceding the breakout in order to have better trade location and to sidestep the potential slippage.

**Setup** Unfolding price action creates many potential support and resistance levels in the market. Most of these are insignificant—most support and resistance levels are nothing more than mirages. However, a very small set of these levels become extremely important, and, when violated, the pressure gives rise to a strong move beyond the level. For breakout trades, this is the first and most important condition: you must identify one of these significant levels that is likely to give good action when broken. If you are working with these levels and their accompanying formations, entering the trades properly, and managing them appropriately, breakout trades can be relatively easy. If you attempt breakout trades at insignificant levels and without a good plan, consistent losses will erode your trading account.

Good breakout levels are usually levels that are clearly visible to all market participants. For instance, there are levels that have been tested cleanly multiple times, and it is obvious to even a casual chart reader that price has been unable to penetrate the level. This creates trading opportunities because some traders will make decisions when price eventually does get through the level. Whether they are stopping out of existing positions, taking profits, or entering on the breakouts does not matter; what does matter is that there will be additional volume and order flow when this important price level is



**FIGURE 6.15** A Very Clean Breakout Level in XOMA

violated. Figure 6.15 shows an example of a very clean level that set up a good intraday breakout in XOMA Ltd (Nasdaq: XOMA).

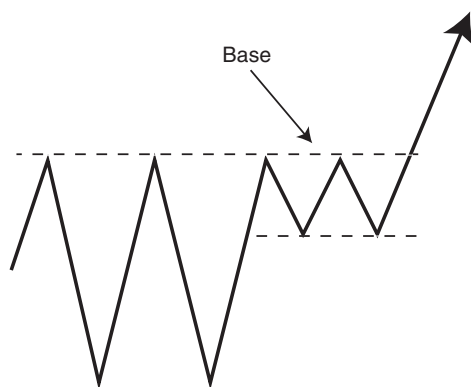
On daily and higher time frames, it is unusual to see perfectly clear levels, but significant and visible support or resistance can still set up good breakout trades. Figure 6.16 shows an example of a typical breakout level on a daily chart, here illustrated in the stock of Cree, Inc. (Nasdaq: CREE). There are two other points to consider on this chart: First, penetrations of levels before the breakout usually seem to expend some of the energy behind the breakout, and often lead to poor trades. The key question is how long and how significant these penetrations through the level were. In Figure 6.16, the level was not perfectly clean, but there was no significant price action above the level preceding the breakout, only small and short-lived failure tests. Second, the actual breakout entry was a gap through the resistance level, which brings some execution challenges to the table. Many traders will be tempted to skip these trades, as they will be forced to enter at significantly higher prices than they had planned, and will be exposed to the danger of a gap failure. This is a mistake because a gap through an important level usually hints at a powerful shift in market dynamics. Some of the best breakouts are “gap and go” trades that open beyond the level and never look back.



**FIGURE 6.16** A Gap Opening Above a Breakout Level in CREE

The best and strongest breakouts will usually be preceded by a formation that indicates buying pressure may be building against the resistance level. (Though this discussion focuses on buying breakouts, the exact patterns apply, inverted, for breakdowns below support.) One common form of this pattern is a tight range near the top of a larger range, as in Figure 6.17. This is another form of accumulation in which the pressure from buyers has pinned the market at a relatively high price. This small range near a resistance level, usually inside of a larger range, is referred to as a breakout base.

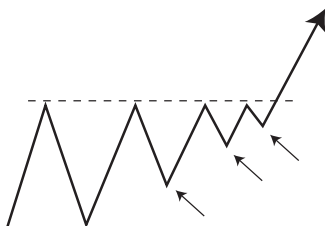
Another variation of this same idea has a market holding successively higher highs into the resistance level, as in Figure 6.18. This is yet another variation on the accumulation theme, as buyers have been willing to buy the market at higher prices on each decline. Though not a bidding war, this pattern does suggest that large buying interests are watching this market and may be building substantial positions. In these cases, the base is not as clearly defined by a chart pattern, which can make stop location more challenging, but the important factor is still the coiling of buying pressure against resistance. Also, the classic cup and handle formation is a variation on this same idea. This is also an illustration of the principle that most classic chart patterns can be better understood in the context of simple length of swing analysis.



**FIGURE 6.17** Schematic of a Breakout Base

**Trigger** The actual entry is in the consolidation preceding the breakout. Positioning in this prebreakout base allows us to avoid having to play in the extreme volatility of the breakout itself. As a rule of thumb, entries in consolidations are usually less precise than entries in trends. Conceptually, we would like to buy as close to the bottom of the base as possible, but the most important thing is to get the position on. There are at least three logical entry triggers, each with some potential drawbacks. (These examples are for long trades, but apply, reversed, to shorts as well.)

- Once the base establishes itself, bid near the bottom of the smaller range. One potential drawback is that this order will be filled only in a declining market, meaning that you are buying against the short-term momentum. Another drawback is that the order may not be filled at all, so it may not be possible to get the position. Sometimes you will identify the range, bid near the bottom, and then watch the breakout as the market never returns to the bottom of the base. In these cases, you will miss the trade. However, the times that the order is filled will result in the best possible trade location, at or very near the bottom of the range.
- Once the base establishes itself, wait for springs (i.e., drops below the support at the bottom of the base that immediately recover back above the support level) and enter on the close of those bars. Though you will now probably be entering with the short-term momentum due to the recovery back above support, not every range features



**FIGURE 6.18** Higher Lows into a Resistance Level: Another Form of Prebreakout Accumulation

springs or upthrusts. In addition, this is a high-maintenance execution technique that requires good focus on subtle details of price action.

- Just get the position on, anywhere in the range. This one isn't pretty, but the reality of trading is that our executions are not always at perfect, ideal points. Imagine we identify a breakout trade that has 10 points of upside potential out of a 5-point large range, with a 1.5-point base near the top of the larger range. If we can buy in that base and give it a 2-point stop, then maybe it doesn't make sense to try to squeeze an extra half point out by bidding near the low of the range.

There is no right or wrong here, and each trader will have to make the decision based on his personality and on how he intends to manage the trade. A trader who takes the proverbial 30,000-foot view and wants to manage things from a big-picture perspective might establish anywhere in the range and just not care about pennies. Another trader might intend to actively trade around and manage the position on the actual breakout; for this trader, pennies might be very significant indeed.

This is also a good place to consider the adverse selection effect of entering on limit orders. Assume that trader A and trader B both identify the same set of 10 potential breakout trades and are buying bases before those breakouts. Also assume, though they would not know it in advance, that five of the trades will be losers. Trader A indiscriminately buys in the base and manages the trades, exiting his losers if they drop decisively below the bottom of the range. Trader B is much more precise with his entries and always bids at the bottom of the range. He is also disciplined about his exits from losing trades, and exits at the same points trader A exits his losing trades. Trader A and B both book their disciplined losers, though trader B's total loss is slightly smaller because of his consistently better trade location. Of the five winning trades, perhaps three went to the bottom of the range where trader B was filled on his position before the breakout. Trader A and B both booked winners, though, again, trader B's winners were slightly bigger, due to better trade location. Assume that the two remaining winning trades never went to the bottom of the base, so trader B was not filled on his entries, while trader A participated fully.

This is a truism of using limit orders, and one that most people choose to ignore: if you enter on limit orders, you will price yourself out of some set of winning trades that never trade to (or, more realistically, through) your limit price *while you will always participate fully in all losing trades*. This is important—traders entering on limits will not be filled on some winners but will be filled on *every* losing trade. In our hypothetical example, we know trader B will miss some of trader A's winning trades. We also know that he will have a small advantage, compared to trader A, on every trade because of better trade location, and the key question is whether that incremental gain is enough to more than compensate for the missed profits from the remaining two trades. This trade-off between market order and limit order entry styles is an important issue to consider, and one that is sorely neglected in the trading literature.

**Stop** There are two separate parts in the life cycle of this trade, requiring two separate approaches to trade management. The trade entry, by definition, is early. We are



**FIGURE 6.19** A Failure below the Bottom of a Range in 5-Minute EURUSD

anticipating a breakout that may or may not happen, so when do we exit if the planned-for breakout does not develop? One simple strategy might be to put a stop below the lowest point reached while the market was in the base, with the plan that if you are stopped out on a temporary drop you probably must reenter the trade. Another approach is to set a much wider stop for the purposes of position sizing and risk management (see Chapter 8), with the idea to stop out before the level is reached if developing price action contradicts the trade. For instance, in Figure 6.19, a trader using the second plan would not have been stopped out when the bottom of the range dropped at A. Quick drops below previous support are to be expected, and rapid recoveries are actually ideal buying opportunities. However, once the market consolidated below that support level at B, the probabilities began to favor a breakdown and another trend leg down, so there was no sense in riding the trade to the initial stop level.

The second issue to consider is how you will manage the trade after the breakout occurs. Here, knowledge of the pullback patterns that occur after breakouts is essential. There are many possible choices, but the plan must be consistent with the realities of market action. If watching \$50.00 as a potential breakout level, many traders would move their stop up to \$50.00 or right under that level once the breakout actually happens. Their logic is that, if the breakout was actually valid, price should not come back below \$50.00. This would seem to make sense, but the market does not work like this. Many excellent

breakouts come back to retest or to exceed the breakout level in an effort to shake out weak-hand players; a good trading plan will not put you in this position of weakness.

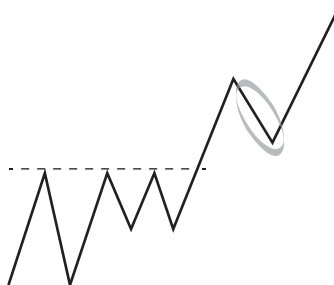
My approach to stops is so consistent that it is boring—I always set stops at places where the market should not go if my trade is correct. If I set a stop there and the market reaches the stop, the trade is wrong and I must exit. Setting a stop somewhere that it can be hit without my trade thesis being violated is anathema to me—why incur additional risk and transaction costs in the normal volatility of the market? Furthermore, it also usually does not make sense to dramatically tighten the stops once the breakout actually occurs, though it is also important to be sensitive to the patterns that suggest a breakout is failing. Distinguishing between these failures and the standard pullbacks of successful breakouts is a key skill for breakout traders to develop.

**Profit Target** Some traders will set ratio-based targets for breakout trades. Common examples use, for instance, measured move objectives based on the width of the preceding range or the base. These make sense for the same reason that all measured move objectives do—they simply define the magnitude of swings that are average for any given market, though it is important to realize that prebreakout conditions often feature abnormally contracted volatility. Ratio-based targets are apt to be unnecessarily conservative in these cases.

In general, I do not favor setting profit targets for breakout trades, because, in the best cases, you just entered a new trend at its inception, and it does not make sense to give up that trade location as long as the trade is working well. Consider all of the possibilities, ranging from outright failure to a single extension above the level to a completely new trend. Just like with all my trades, I will take partial profits at a level approximately equal to my initial risk in the trade, and then will usually hold the remainder as long as the new trend appears to be intact, perhaps taking partial profits at other inflection points as the trade develops. Once you have a breakout trade that has gone through one successful, confirming pullback, it is simply a trend trade and can be treated as such, managing the pullbacks as in any other trend.

**Comments** We should also take a minute to consider simple channel breakout systems. It is well known by now that the core entry technique of the system the Turtles were taught was a breakout of a 20-day or 55-day channel. If you examine these levels carefully, you will see that most of them violate the rule I gave that good breakout levels have to be very real, visible levels in the market. In fact, most of these 20-day or 55-day highs/lows are not points that your eye would be drawn to on a chart. The success of some of the Turtles has grown into the stuff of legend and myth, but the breakouts were not the important part of that system. The general trading public has the idea that the Turtles traded breakouts of 20-day highs, but, in reality, much of their success was due to systematic approaches that were designed to capture every trend in markets that trended well at the time. The trade-off was that they had to accept many small losses on entries that did not develop into good trends, but, for their system to work, they *had* to be involved at the start of every potential trend. Our work in this book is focused on shorter-term swing trades around breakout levels, which is a completely different kind of trading.

## BREAKOUTS, ENTERING ON FIRST PULLBACK FOLLOWING



### Trade Type

Support/resistance breaking.

**Concept** The first pullback after a breakout offers a spot to initiate a position in the direction of the new trend supported by the confirmation of a successful breakout. This entry also avoids the volatility of the actual breakout area, and the uncertainty inherent in positions established in the prebreakout base.

**Setup** The market has made a successful breakout of an important level. Furthermore, there is good activity (volume, volatility, and price action) beyond the level, proving that it was a valid breakout. The initial upthrust exhausts itself, the market rolls over, and a pullback begins.

**Trigger** This pullback can be treated as a standard pullback, with any of the standard pullback trigger entries.

**Stop** If the pullback is treated like any other pullback, the logical choice is to use the same stops you would apply to any pullback trade. There are two other levels worth considering here: the actual breakout level itself and any prebreakout reference level (e.g., support in the base, or the highest low preceding the breakout). Many traders will work with the idea that the breakout level should be a good price for stops, but it is not. Some of the strongest continuations will drop back below the level, stopping out naive weak-hand short-term traders, and then turn to trade much higher. These traders, now trapped out of the market, will have to chase it higher, adding additional impetus to the move.

However, a good prebreakout level usually is a serviceable reference, and it is usually possible to tighten stops enough that a loss does not have to be taken to this level. (This level may still serve a useful purpose as a last-ditch exit and as a reference for position sizing.) It is very hard to justify holding a simple breakout pullback that drops below the pivot low of the prebreakout base, as this type of action is much more indicative of a

failed breakout. However, it is not uncommon to see failed breakouts spend more time consolidating before breaking out and working on a second breakout attempt. These are certainly not the cleanest and easiest trades, and most traders will find that they enjoy the best success restricting their involvement to first breakout attempts.

It is easy to overcomplicate these trades and to try to factor too many additional levels and patterns into the trading plan. At the end of the day, the first pullback following a breakout is nothing more than a pullback; there is no need for a complicated trade management plan if you already have the skills to trade pullbacks on other contexts.

**Profit Target** These are standard pullbacks, so standard pullback profit targets apply with one caveat: trends from good breakout levels tend to be exceptional trends. There is a better than average chance that any ensuing trend will extend for several legs with strong impulse moves. It still makes sense to maintain the discipline of taking partial profits, but it also makes sense to allow yourself the opportunity to participate in the potentially outsized trend run. This is another place where as a trader you will need to tailor the plan to fit your personality, but, of course, the key is to actually have a plan. Do not put yourself in a situation in which you have to make reactive decisions on the fly.

**Comments** In some sense, this is a hybrid trade, combining characteristics of both breakout and pullback trades, but it can be simplified further: it is really nothing more than a simple pullback trade.

One last thought on breakout trades: we have not considered the higher time frame in these trade setups, and it often does not matter. A clear breakout level on the trading time frame will usually be an even clearer resistance level on the higher time frame, but there are cases where the breakout is further supported by the higher time frame structure. For instance, if an upside breakout on the trading time frame comes near the bottom of a higher time frame pullback in an uptrend, then the trading time frame breakout is essentially a breakout entry into the higher time frame pattern. Time frames often have complex interactions with influences flowing in both directions, but these considerations can sometimes add significant support to individual trade setups.

Al Brooks, in *Reading Price Charts Bar by Bar: The Technical Analysis of Price Action for the Serious Trader* (2009), discusses many variations of breakout trades. Though many of his comments and trading ideas are specific to intraday index futures, most of them can be applied with some modification to other markets and time frames. Brooks's approach is different from mine in that he focuses much more on the minute details of each individual price bar and its relationship to previous bars, while I tend to think there is much more noise and randomness in the market at most times. Regardless, his book offers a valuable perspective and good food for thought.

## FAILED BREAKOUTS



### Trade Type

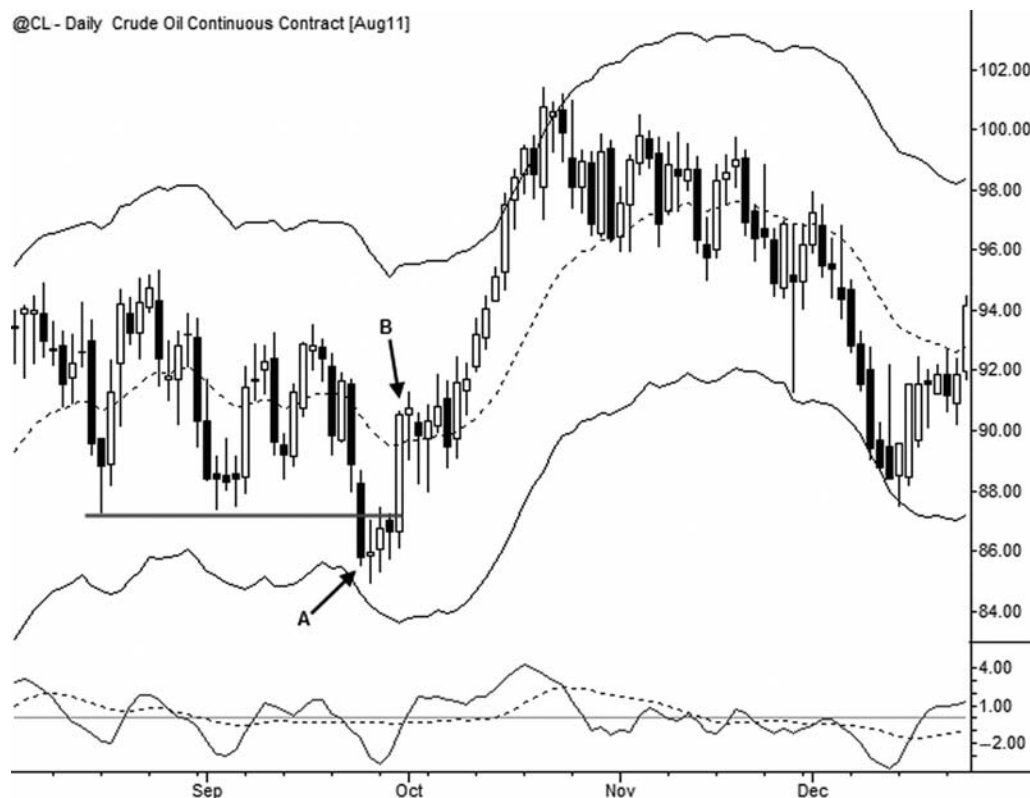
Support/resistance holding.

**Concept** Most breakouts fail.

**Setup** When most traders think of breakout trades, they think of big, dramatic winning trades, and it is not hard to find examples like this. However, the trader actually trading breakouts quickly comes face-to-face with a harsh reality: failed breakouts are more common than winning breakouts. This is not an indictment of the breakout trading concept, because exceptional reward/risk ratios can compensate for lower probability. Furthermore, good breakout traders know how to prequalify their trades by focusing on the patterns that tend to support successful breakouts and may have a higher winning percentage than might be expected. There certainly is money to be made trading breakouts, but it is also worthwhile to spend some time thinking about the patterns associated with breakout failures.

It is difficult to nail these patterns down because it is not uncommon for good breakouts to have reactions that violate the breakout level. Imagine the frustration of the trader working with this flawed plan: pay into the actual breakout, and flip the position short if the breakout level does not hold. In the very common case of a volatile breakout with a pullback that violates the breakout level, this trader will first take a loss on the long position, and will now be positioned short as the pullback in the new uptrend begins its advance. This is a futile plan, but many developing traders fall into this trap because they attach too much importance to the retest of the actual breakout level. It is important to understand how the market really moves, rather than clinging to some idea of how the market logically *should* work.

There are two setup conditions to consider: the strength of the move beyond the breakout level, and the character of the first reaction after the breakout. Good breakouts should have strong momentum, volume, and interest beyond the level. If this does not happen, it is more likely that the breakout will fail, perhaps painting a spring or upthrust outside the previous support or resistance level. In successful breakouts, the first reaction should be controlled and in proportion to this breakout thrust. It should look like a good pullback in the new trend, for that is exactly what it is. If the breakout fails, it



**FIGURE 6.20** A Failed Breakout Below Support in Crude Oil

will be through a failure of this first pullback; this is a critical point in breakout trading. If the first reaction is very strong (i.e., the first downswing after an upside breakout or vice versa for a breakdown through support), it suggests a failure of the break interest and greatly increased probability of trade failure. This is potentially confusing, so some examples may help to clarify.

Figure 6.20 shows a failed breakdown attempt below support. The actual bar of the breakout was a good entry, showing strong momentum through support, and the subsequent consolidation was also consistent with the breakout play. Most traders trading this pattern should have been short, and should have been holding through the three small bars following the point marked A. Though not a large pattern, these bars were a pull-back or consolidation near the extreme of the previous downthrust and below previous support. However, even with this generally constructive setup, the trade failed as buyers stepped in and swept the market back above support at B, possibly fueled by additional short-covering volatility. This is nothing more than a classic pullback failure via strong countertrend momentum emerging in the pullback.

Figure 6.21 shows another example of a failed breakout, this time an upside breakout in Goldman Sachs (NYSE: GS). There were several elements that should have put



**FIGURE 6.21** A Failed Upside Breakout Attempt in GS

the long pullback trader on warning: the actual breakout at A was not on good momentum and did not show strong conviction. The pullback (four black candles beginning two bars after A) retraced most of the breakout thrust. Though the penetration back through the breakout level is not in itself cause for concern, it is not good to see so much of the breakout retraced so easily. The actual failure came at point B, as the stock put in a failure test at the previous high. This is one of the standard ways in which pullbacks fail and a good opportunity to use another trading pattern (the failure test from the beginning of this chapter) in a supporting context. Good trading is nothing more than the disciplined application of a few relatively simple fundamental building blocks.

**Trigger** Conceptually, this is the most problematic of the trade setups because we have to strike a balance between waiting for confirmation that the breakout has failed while still getting a good trade location. In terms of actual execution, *the breakout failure is nothing more than a failed pullback*. Breakout traders need to understand that the pullback pattern is a critical building block for these trades, and it is important to understand the patterns that suggest pullbacks failing and continuing.

**Stop** Saying most breakouts fail trivializes many of the issues we face trading these patterns because of the extreme volatility associated with breakouts and their failures. Being caught on the wrong side of a breakout trade (whether a successful or a failed breakout) is bad news. Stop placement is fairly simple, as the ultimate stop is above the extreme of the initial pullback thrust, but in this trade you must respect your stop fully and without question. If the stop is hit, get out of the trade. Do not try to trade around it; do not try to average your price. Just get out. You may play these games and get away with it 30 times in a row, but the 31st trade could wipe out many months' profits. There is danger here—real tail risk—that is hard to comprehend and impossible to quantify.

**Profit Target** There are two likely resolutions to these trades. In some markets (for instance, longer-term commodities) failed breakouts can be absorbed into a large-scale consolidation. After spending some time working off the failure, the market may make another breakout attempt and continue to grind higher. The second possibility is that the market may truly melt down and collapse after a failed breakout. This outcome is slightly more likely in shorter time frames, but what we are looking for here is a violation of the base before the breakout and wholesale panic as trapped traders scramble to adjust positions. A good trading plan will consider both possibilities, with a provision to take partial profits at a relatively close target while holding a portion for a larger swing.

From a practical standpoint, it probably makes sense to use the same profit targets on all trades, taking first partial profits at a point equal to the risk on the trade. In my own trading plan, I tend to be aggressive in taking those profits on failed breakout trades, perhaps even exiting more than half of my position at the first target. As in all other trades, I will adjust that target to respect the geometry of the pattern. If a target is beyond a clear and significant level, adjust it by moving it slightly inside the level. This is nothing more than trading common sense.

**Comments** This is the most complex and least well defined of the major trade setups. Newer traders are probably best advised to not focus on this trade until some success is achieved with the other setups, but it is important to study these failure patterns even if you only intend to trade breakouts in the direction of the initial breakout. Awareness of how patterns fail and how trades fail can help you limit your losses and manage losing trades with equanimity. After you have traded many breakouts and internalized many variations of these patterns, you will begin to develop some intuition about them. Until then, the guidelines in this chapter will help you avoid some of the more serious and more obvious mistakes in trading these patterns.

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## SUMMARY

This has been a fairly long list of potential trading patterns, presented in the order in which I believe most traders should learn them. We started with the simplicity of the

failure test, progressing to more complex pullbacks, then to the special situation of pullbacks after trend changes. Last, the volatile set of breakouts were added, and failed breakouts, which can be touchy, subjective, and dangerous, bring up the rear, so the progression is from simple and well-defined to complex and potentially confusing. There are only three core concepts here, which express the tendency of the trend to continue and the tendency of support and resistance to both hold and break. The other trade setups are derived from combinations of these core trading concepts. If this chapter has been confusing, consider this alternate classification.

### **Primary Trades**

- Pullback: The sine qua non of trend trading patterns (trend continuation).
- Failure test: A quick-and-dirty countertrend entry with a well-defined risk point (support/resistance holding).
- Breakout: The ultimate expression of support/resistance failing.

### **Derived Trades**

- Anti: A trend termination pattern that uses the pullback pattern as an entry and for confirmation.
- Buying support in a pullback: Basically a failure test entry into the pullback pattern.
- Paying a breakout of a pullback: A combination of a lower time frame breakout with a trading time frame pullback.
- Breakout, entering in base before: Anticipatory entry into a breakout trade; may use support at the bottom of the base as an entry trigger, so the trade is actually a support holding trade.
- Breakout, entering on first pullback following: Puts a simple pullback entry and probability in the context of a breakout trade.
- Breakouts, failed: A more complex version of the failure test; many of these are simple higher time frame failure test trades, but the motivating patterns are the failure patterns of pullbacks.

This is not an exhaustive list of the trade entries I have used successfully, but it is a list of the most important ones. Notice the trades that are *not* here: no trades in ranges unless the range is a more significant structure in another time frame, no simple buying or selling at support levels, and no fading overextended markets. I have not found these to be reliable trades, nor have they been profitable for me over a very large sample size. If I have a burning desire to execute one of these trades, I can usually accomplish it within one of the trade structures I have already set out. For instance, rather than simply shorting into a runaway bull market that I feel has gone too far, I can wait for the market to make a buying climax and then enter on the Anti. The trade may still fail, but it is at least supported by a real pattern with a defined risk point.

It is also interesting to consider where these trading patterns fall in the course of the idealized market structure outlined in Chapter 2. In accumulation, we can buy failure tests of the low of the range, especially if the higher time frame supports an advance. The

breakout trades naturally belong at the transition between accumulation and markup. The pullback variations are, of course, the ideal tools for trading both the markup and markdown periods. The transitions from markup to distribution (and from markdown to accumulation) are a bit more problematic. For example, we actively try to *avoid* having positions within those areas until they are set to break out, and even catching the exact end of the trending period may result in meager profits as the market simply chops sideways. Regardless, the Anti pattern is the ideal tool to catch these turns, and it is also common for trends to end with a final failure test at the highs.

The patterns in this chapter are more than a menu of trade setups to be used à la carte according to the trader's whim. Rather, this simple set of trading patterns offers a comprehensive tool kit for approaching market structure and price action in any market and any time frame. Consider the cycle:

- Buying support in a range via failure tests (springs) near the bottom of the range.
- Entering in a base preceding a breakout.
- The actual breakout.
- The first pullback following a breakout.
- Pullbacks as the new trend gains steam.
- The possibility for complex pullbacks as the trend matures. Monitoring the strength of pullbacks gives insight into trend integrity.
- A possible failure test at the eventual high of the trend.
- An Anti at the high of the trend.
- Selling resistance near the previous trend extreme via failure tests (upthrusts).
- Entering early in anticipation of a breakdown through support.

A trader can trade this entire cycle, or can use these trades as signposts to monitor the health of the market and its transition from one regime to another. Within this relatively simple set of patterns lies the key to all price action and market structure. Properly applied, this sequence is nothing less than a complete analytical methodology.